OFFICE OF THE STATE BUDGET

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Office of the State Budget

Report on the Evaluation of Internal Controls
For the Biennial Period Ending September 30, 2004

Background and Overview

State law (MCL 18.1485) requires the head of each principal department to establish and maintain an internal accounting and administrative control system that includes, at a minimum, all of the following elements:

- A plan of organization that provides separation of duties and responsibilities among employees.
- A plan that limits access to the principal department's resources to authorized personnel that require access within the scope of their assigned duties.
- A system of authorization and record-keeping procedures to control assets, liabilities, revenues, and expenditures.
- A system of practices to be followed in the performance of duties and functions in each principal department.
- Qualified personnel that maintain a level of competence.
- Internal control techniques that are effective and efficient.

The law further requires that the head of each principal department document the system of internal control, communicate system requirements to department employees, assure that the system is functioning as prescribed, and modify the system, as necessary.

Biennially, the head of each principal department must provide a report on the department's evaluation of the system of internal control. At a minimum, the report must include a description of any material internal control weaknesses, a corrective action plan, and a listing of each audit or investigation performed by the department's internal auditor.

Detailed guidance regarding the establishment, maintenance, and evaluation of internal controls and the preparation of the biennial report can be found in the *Evaluation of Internal Controls – A General Framework and System of Reporting* (General Framework), which is available on the Office of Financial Management (OFM) website at www.michigan.gov/ofm.

Purpose of this Report

The purpose of this report is to summarize the results of OFM's review of the processes used by each of the nineteen principal departments to establish, maintain, and evaluate internal controls and to prepare the biennial report for the period ending September 30, 2004. The focus of OFM's review was to identify best practices that can be employed across all departments and to develop an action plan to address areas needing improvement.

In conducting the review, OFM developed a list of attributes it considered important to ensuring an effective evaluation and reporting process. OFM then determined which of these attributes had been incorporated in the department's planning, evaluation, and reporting processes by visiting each of the departments to review documentation and conduct interviews with Designated Senior Officials (DSOs), Internal Auditors, and/or other program staff.

OFM's review of the departments' planning activities focused on who coordinated the evaluation process and report, how the information was shared among management throughout the departments, how the departments' segmented their activities for review, and whether monitoring plans or similar documents existed which detailed the departments' approach to controls and the processes for evaluating them.

OFM's review of the departmental evaluation efforts were geared toward the activities and internal control components evaluated, the tools used to conduct the evaluations, and the documentation retained to support conclusions. OFM separated its assessment of evaluation and reporting activities between information technology (IT) controls and non-IT controls in order to assess the relative effectiveness of the different tool sets used for evaluating IT and non-IT controls.

OFM's review of reporting practices centered on whether the extent of activities reviewed and the documentation of the evaluation processes were sufficient to support the departments' overall conclusions regarding their internal control system.

After completing the review, OFM provided feedback to each department regarding areas of strength and areas in which improvement was needed. Feedback was also solicited from departments regarding ideas for improving the overall process.

Best Practices

Information Sharing

Several departments utilized websites to share tools and instructions throughout the department, thereby providing participants with insight into the departments' monitoring plan; instructions for conducting evaluations and drawing conclusions; blank and completed (sample) evaluation tools; FAQs; contact information; and other reference materials. This approach was helpful in translating OFM's general guidance into an action plan for how the department was conducting its evaluation and completing the corresponding report.

Audit Programs

While all department Internal Auditors were involved in the evaluation and reporting process to varying degrees, some Internal Auditors conducted structured reviews using audit programs. The audit programs provided a means to specifically identify the oversight conducted and included tasks such as reviewing the completed evaluation tools for completeness, reasonableness, and specificity, verifying that the segmentation approach included sufficient departmental coverage to support conclusions reached, and verifying that material weaknesses identified in the prior cycle were included in the current reporting cycle.

External Audit Findings

Over half of the departments implemented systems to collect, document, and monitor audit findings identified during the course of external audits. These practices positively impact the internal control system by incorporating the previously identified control weakness into the department's evaluation processes, thereby helping to ensure that the weakness is continually monitored and mitigated.

Feedback

Several departments commented that they benefited from following up with participants to receive constructive criticism regarding the evaluation. Several departments also shared evaluation feedback with participants to increase their awareness of weaknesses with the segments they evaluated and to also educate them on proper completion of the evaluation worksheets and implementation of sound internal controls. This was useful in identifying areas for improvement.

Areas for Improvement

Continuous Evaluation Process

With the exception of a few departments, internal control evaluations are not ongoing processes that are integrated into the everyday operations of each department. The evaluation process appears to be viewed as a routine that occurs every two years, when the biennial report is required. Although a control system may be adequately designed, the departments cannot ensure that controls are functioning as intended without sufficient monitoring. We noted instances in which departments had not identified necessary monitoring activities or we were told that monitoring/testing of the controls had not occurred. We often heard that program staff ceased to recognize the value in conducting the "biennial" evaluation. In fact, there is little value in a biennial evaluation; rather the evaluation should be ongoing and the report biennial.

Documenting the Evaluation Process

Documentation supporting the evaluation processes and biennial report was lacking in a number of departments. Monitoring was the primary component that was most often not documented. Only about half the departments had maintained sufficient documentation of their evaluation efforts to support the director's overall conclusions. If departments were to document the control system in place and modify it as changes occur to processes, they could then focus efforts on monitoring and documenting the oversight that occurs throughout the period. The biennial report would then become more of an effort of compiling results and drawing conclusions, rather than the seemingly onerous task of completing comprehensive evaluations and reporting within the span of a couple of months.

Evaluation of Information Technology Controls

Only half of the departments completed a risk assessment in an attempt to identify mission-critical IT applications. Some did not possess an inventory of their IT applications to begin such an assessment process. Consequently, only about half of the departments adequately documented their evaluation and conclusions regarding IT controls. Many departments expressed frustration with the evaluation tools, commenting that they were too technical or required too much time and effort. There were also issues regarding ownership of IT applications.

In terms of conducting IT evaluations, some departments struggled, but succeeded in completing an evaluation, while others extended minimal effort, because they recognized that, without the necessary expertise, the evaluation would yield little benefit. Adequate evaluation and reporting of IT controls requires a collaborative effort between DIT staff (serving as technical experts), department program staff (providing details regarding the day-to-day operations of the applications), and OFM (providing relevant tools and guidance) to complete these tasks.

Internal Auditor Role

In half of the departments, internal auditors were the primary coordinators of the evaluation and reporting processes. While the Designated Senior Official (DSO) holds primary responsibility for the department's internal control system, directing the evaluations and reviewing results were often delegated to Internal Auditors. OFM is supportive of an environment in which Internal Auditors utilize their expertise to improve the evaluation and reporting processes by working in collaboration with management to recognize, understand, and appropriately control risks. However, OFM also believes that Internal Auditors should independently verify the integrity of the department's system of internal control, as discussed in the General Framework.

OFM Action Plan

General Framework

The last revision of the General Framework occurred in 1999. With increased emphasis on IT, revision is necessary to highlight and discuss the nuances associated with evaluating those controls. Also, the lines of responsibility between those of DIT and the departments must be established to clarify the confusion that appears to currently exist. The information we derived from the department reviews, feedback received during our visits, and other control-related issues that have arisen can be addressed within a revised General Framework. For example, although not specifically discussed during our department visits, recent attention has been paid to controls in existence at third party service organizations that process transactions on behalf of the State, and agencies could benefit from relevant guidance. OFM has begun revising the General Framework and will publish it within the Financial Management Guide. (Projected completion by January 2007.)

IT Evaluation Tools

OFM will formulate a workgroup with the Internal Auditors and/or other interested parties to identify methods of improving the tools for evaluating IT-related controls. Although the existing tools provide comprehensive coverage of IT controls, departments struggled to utilize them appropriately. OFM is committed to assisting agencies by providing relevant tools that are written in a user-friendly format. (Recommendations for improvements completed by September 2006.)

Inventories of IT Applications

OFM will work with DIT to ensure all departments receive inventories of their IT applications, thereby subjecting them to risk assessment and possible evaluation. According to departments, inconsistency exists in the information shared between DIT and the departments, with some departments commenting that they are unaware of the number of applications being run within their department. (Anticipated delivery of inventories by October 2006.)

IT Risk Assessment Tool

Departments expressed a need for a risk assessment tool that will assist them in identifying mission critical applications. The extent of applications utilized by departments precludes a comprehensive evaluation of all applications, therefore it is imperative that departments focus their attention to critical applications; those which directly impact the department's ability to fulfill its mission. OFM will work with DIT and agencies to develop a tool that will enable departments to more efficiently evaluate applications, to help ensure that they devote their attention to those deemed to be mission critical. (Anticipated completion of the evaluation tool by September 2006.)

Third Party Service Organizations (TPSOs)

With the recent attention given to third party service organizations that process transactions on behalf of the State, the Financial Management Guide (FMG) will be amended to include a section specifically on this issue. Transactions processed by outside entities possess similar risks, and sometimes higher risks, than those processed by State employees and the State's IT applications. Therefore, the FMG will require departments to consider controls at TPSOs in a fashion similar to departmental controls and evaluate how the transactions processed by TPSOs impact the departments' overall control system. Also, the policy will require departments to provide an annual inventory of third party service organizations to OFM, thereby allowing OFM to monitor their impact on the State's overall internal control system and ensure that the risks are adequately evaluated and mitigated. (Projected completion by January 2007.)

Internal Auditor Certification

Current practice requires the department Internal Auditors to review the nature of internal audit evaluation activities upon which the biennial report is based and certify to the department Director whether the evaluation was carried out in a "reasonable and prudent manner". While this responsibility is not intended to preclude the Internal Auditor from actively consulting with and assisting the DSO or others, OFM does not believe that the existing certification provides sufficient specificity for the Internal Auditor to notify the department Director of weakness(es) that exist in the processes. While the Internal Auditor is certainly at liberty to expand upon the certification that is forwarded to the Director, OFM believes that more precise representations should be included in the certification, providing the Director with more detail of the activities that occurred within the department upon which the Internal Auditor is certifying. OFM will work with the Internal Auditors to identify those relevant representations and incorporate changes for the next report cycle. (Projected completion of new certification letter by October 2006.)

Audit Program

As previously mentioned, a number of department Internal Auditors used audit programs to guide their review. OFM will form a workgroup of Internal Auditors, using existing examples as a foundation, to develop a standardized audit program that can be shared with all departments. The audit program will help Internal Auditors who are not currently using one to better document the review that was conducted, provide consistency across departments regarding the scope of the auditors' reviews, and give some assurance to Internal Auditors that their review processes are comparable with their peers. (Projected completion of audit program by October 2006.)

External Audit Findings

OFM maintains a database of all findings reported in OAG audit reports. Although some departments have developed similar systems, OFM will biannually provide to departments the OAG findings from reports released during the preceding six months. It is OFM's intent that departments will include the noted weaknesses in their evaluation efforts, to help ensure that the weaknesses get corrected and continue to be mitigated. (First report provided in April 2006.)